

# Towards a Uniform Standard: The Effect of Close Corporation and Partnership Restrictive Agreements on Federal Estate Tax Valuation

The Revenue Act of 1916, with its provision for a tax on the value at a decedent's death of all property "real or personal, tangible or intangible,"<sup>1</sup> spawned the estate tax *bête noire* of taxpayers, courts, and revenue collectors—the valuation of closely held business interests subject to restrictive agreements.<sup>2</sup> By 1932 the problem was clearly defined. Two federal courts, ending a fifteen year period of judicial silence,<sup>3</sup> examined and determined the status of restrictive agreements in valuation proceedings. The decisions were diametrically opposed: one court held restrictive agreements binding for valuation purposes,<sup>4</sup> and the other found them nondeterminative of actual value.<sup>5</sup> Although these antithetical holdings have been the source of recurrent litigation, legislative reform, and voluminous commentary, the basic issue remains unresolved.<sup>6</sup>

This Note argues that the restrictive agreement dispute is best understood as the product of a general effort to implement two often conflicting objectives: minimization of tax avoidance by taxing a de-

1. Revenue Act of 1916, ch. 463, § 202, 39 Stat. 777 (current version at I.R.C. § 2031(a)).

2. For discussions of the restrictive agreement problem, see Corneel, *Valuation Techniques in Buy-Sell Agreements: Effect on Gift and Estate Taxes*, 24 N.Y.U. TAX INST. 631 (1966); O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773 (1952); Sheed, *Stockholders' Restrictive Agreements and Their Tax Consequences*, 91 N.J.L.J. 5 (1968); Stechel, *Restrictive Buy-Sell Agreements Can Limit Estate Tax Value of a Business Interest*, 44 J. TAX. 360 (1976). "[I]t is believed that the shares of at least half the corporations in this country are subject to such restrictions." 2 F.H. O'NEAL, *CLOSE CORPORATIONS: LAW AND PRACTICE* § 7.02, at 7-6 n.5 (2d ed. 1971).

3. See *Estate of Schulz v. Commissioner*, 14 B.T.A. 419, 420 (1928) ("[W]hether a third party is bound by the price fixed by the directors has not, as far as we know, been decided and we are not called upon to decide it here . . .").

4. *Lomb v. Sugden*, 82 F.2d 166, 167 (2d Cir. 1936) ("[A]n option contract, giving stockholders a right to purchase at a specified price, upon the owners [sic] sale or death, limited the value of the stock to the low price at which he or his executors were obliged to sell it.") (citing *Wilson v. Bowers*, 57 F.2d 682 (2d Cir. 1932)).

5. *City Bank Farmers Trust Co. v. Commissioner*, 23 B.T.A. 663, 669 (1931) ("Although the parties can restrict the sale price of the stock as between themselves they can not, by such a contract, restrict the right of the Government to collect taxes upon the actual value of the stock.")

6. See *In re Cowles' Estate*, 36 Wash. 2d 710, 715, 219 P.2d 964, 966 (1950) (describing restrictive agreement dispute in both federal and state tax contexts: "[T]he whole matter is in a state of discouraging confusion.")

cedent's estate at its full value and facilitation of succession in a closely held business upon the death or retirement of a stockholder or partner. It contends that the conclusiveness of a restrictive agreement on estate tax valuation of a business interest should be determined by an objective appraisal of the enforceability and restrictiveness of the contract terms, the mutuality of the parties' business interests, and the net economic effect of the arrangement. The Note recommends a new test, derived from the insurance and reciprocal trust models, to limit tax avoidance and ease succession upon the death of a partner or shareholder.

## I. Summary and Critique of Traditional Standards

There have been numerous legislative and judicial attempts to develop standards for determining the federal estate tax valuation status of restrictive agreements. Existing tests do not fulfill either the taxation or succession purposes underlying the restrictive agreement exception, and as a result, judicial manageability and uniformity have suffered.

### A. *The Statutory Scheme*

Under the present Internal Revenue Code and supplementary regulations, any security held by a decedent at the date of his death is includable in his taxable gross estate at its fair market value.<sup>7</sup> Fair market value is defined as the price at which the stock or bond would be exchanged in a hypothetical transaction between a willing buyer and a willing seller.<sup>8</sup> When there exists a market for the security on, for example, a stock exchange or over-the-counter market, the willing buyer-willing seller test is easily applied: the actual selling price of the security determines the fair market value.<sup>9</sup>

In the close corporation context,<sup>10</sup> in which stock is not freely traded,

7. "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." I.R.C. § 2031(a). Shares of stock, bonds, and interests in businesses as a whole are "property" for estate tax purposes, Treas. Reg. § 20.2031-1(b), T.D. 6826, 1965-2 C.B. 367, 368, and are valued at fair market value, Treas. Reg. § 20.2031-2(a) (1958).

8. Treas. Reg. § 20.2031-1(b), T.D. 6826, 1965-2 C.B. 367, 368. Because fair market value is considered a question primarily of fact, the Internal Revenue Service will not issue advance rulings "involving the prospective application of the estate tax to the property or the estate of a living person." Rev. Proc. 64-31, § 3.02(3), 1964-2 C.B. 947, 950.

9. Treas. Reg. § 20.2031-2(b), T.D. 7327, 1974-2 C.B. 294, 295.

10. "Close corporations" are:

those corporations the shares of which are owned by a relatively limited number of

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measurement of a decedent's business interest for federal estate tax purposes is a formidable task. The Code provides that the fair market value is to be derived from a careful analysis of all available financial data and relevant factors.<sup>11</sup> The appropriate weight to be accorded to each factor is basically left to the appraiser's discretion; the Code requires only that the nature of the company's business be figured into the calculation of the security's value.<sup>12</sup> The valuation of an unincorporated business interest is handled similarly.<sup>13</sup>

When a decedent's closely held or unincorporated business interest

stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term "fair market value."

Rev. Rul. 59-60, 1959-1 C.B. 237.

Rev. Rul. 59-60, however, should not be interpreted as defining close corporations exclusively in terms of a family-held business. R. STEPHENS, G. MAXFIELD, & S. LIND, *FEDERAL ESTATE AND GIFT TAXATION* § 4.02(3)(f) (1979). Treas. Reg. § 20.2031-2(f), T.D. 7312, 1974-1 C.B. 277, 278, embraces situations in which "actual sale prices and bona fide bid and asked prices are lacking." The preferred definition was articulated in *Brooks v. Willcuts*, 78 F.2d 270, 273 (8th Cir. 1935):

[T]he term "close corporation," as used in the regulation, was not used in the sense in which the term is used in the law of England, where it means a corporation which fills its own vacancies, or in which the power of voting is held perforce manipulation under fixed and well-nigh perpetual proxies . . . but in accord with the popular, or vernacular understanding.

11. Under the regulations, valuation is determined by considering the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors, which include

the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange . . . [and] nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.

Treas. Reg. § 20.2031-2(f), T.D. 7312, 1974-1 C.B. 277, 278; see Rev. Rul. 59-60, 1959-1 C.B. 237, 238, *supplemented by* Rev. Rul. 77-287, 1977-2 C.B. 319, 320-21.

12. See Rev. Rul. 59-60, § 5, 1959-1 C.B. 237, 242 ("In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.")

13. Fair market value of an unincorporated business interest is an estimate of the price at which a willing buyer would acquire the interest from a willing seller, both having full access to all material information. As in the close corporation context, the Code supplies only guidelines: the relevance and significance of each factor are to be decided by the evaluator. See Treas. Reg. § 20.2031-3 (1958); Rev. Rul. 68-609, 1968-2 C.B. 327, 328. But see Korner, *Issues and Problems in Valuing Closely Held Business Interests for Estate Tax Purposes, Especially Partnership Interests*, 30 N.Y.U. TAX INST. 185 (1972) (because of significant distinctions between stock and partnership interests, different approaches to estate tax valuation should be provided in Code).

is owned subject to a restrictive agreement,<sup>14</sup> the foregoing approach to valuation may be inapplicable. On the general theory that such an arrangement limits an executor's choice of market for the sale of a decedent's stock, federal tax authorities will often accord restrictive agreements significant, if not conclusive, effect in valuation proceedings.<sup>15</sup> Although the stated value in a contract among private parties does not legally preclude further appraisal for estate tax purposes of the partnership's or company's actual worth,<sup>16</sup> it is, in practice, usually accepted in cases in which agreements with a restriction on disposition of the interest both during the decedent's lifetime and at his death represent bona fide business arrangements for adequate and full consideration.<sup>17</sup>

Even though each of these criteria may present difficulties in application, the fundamental problem arises from the inherent ambiguity involved in defining fair market value. That term is susceptible to two general interpretations: "market value," defined as the price at which the owner could actually sell his property,<sup>18</sup> and "intrinsic value," defined as the price one would pay for the "sum of all rights and powers incident to ownership."<sup>19</sup> The Treasury Regulations adopt the first market standard for estate tax valuation of ordinary securities,<sup>20</sup> apply the intrinsic value standard for closely held or unincor-

14. The term "restrictive agreement" is generally understood to refer solely to limitations on the sale or disposition of stock. However, it "may embrace stock option contracts, partnership agreements, buy and sell agreements, transmutations of property interests from statutory concepts, conversions of interests in property from one type to another, and agreements entered into between shareholders or other proprietors of business or property interests affecting the transferability or extent of their interests." 1 J. MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION § 9.02, at 551 (1959 & Supp. 1980).

There are three basic forms of restrictive agreements. Under a "first refusal" or "first offer" arrangement, the owner of the stock must first offer it to a specified purchaser at a designated price before he is free to sell it to others; initiative rests entirely with the owner. Under an "option" agreement, the specified purchaser is given the right to purchase the stock at a fixed or determinable price for a specified period of time; initiative rests entirely with the potential buyer. Under a mandatory "buy-sell" agreement, the owner is obligated to sell for a fixed or determinable price at a designated time and the buyer is obligated to purchase; initiative has been taken away from both buyer and seller. Butala, *Restrictive Agreements: Their Effect Upon the Tax Valuation of Corporate Stock*, 105 TRUSTS & EST. 15, 15 (1966).

15. Cf. Treas. Reg. § 20.2031-2(h) (1958) (detailing circumstances under which option or contract prices are disregarded in determining estate tax value of securities).

16. See Rev. Rul. 157, 1953-2 C.B. 255 (when close corporation restrictive agreement does not reflect consideration for goodwill, Commissioner is not precluded, for federal estate tax purposes, from evaluating stockholder's interest in business to include goodwill).

17. See Treas. Reg. § 20.2031-2(h) (1958); Rev. Rul. 54-76, 1954-1 C.B. 194.

18. 2 J. BONBRIGHT, VALUATION OF PROPERTY 1020 (1937).

19. *Bromley v. McCaughn*, 280 U.S. 124, 137 (1929) (origin of phrase).

20. See Treas. Reg. § 20.2031-2(a) (1958).

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porated business interests,<sup>21</sup> and return to the market standard when such interests are subject to certain restrictive agreements.<sup>22</sup> This manipulation of the definition of fair market value and the resultant grant of special estate tax treatment to certain restricted business interests evince a strong legislative intent to encourage smooth and orderly transitions in partnership or close corporation ownership.<sup>23</sup>

### B. *Judicial Doctrines*

Judicial standards have been developed to interpret the statutory rules regarding valuation of a decedent's business interests held subject to a restrictive agreement. Although these standards are often incongruous and confined in application to specific factual contexts, the courts generally recognize, as a starting point, the validity of close corporation transfer restrictions that are reasonable and contained in articles of incorporation, by-laws, or shareholders' agreements. The reasonableness of the restraint on alienation has been judged by various factors, including the corporation's size,<sup>24</sup> the nature of the

21. See *id.* § 20.2031-2(f).

22. See *id.* § 20.2031-2(h).

23. A congressional intent to facilitate the continuity of close corporations upon the retirement or death of a shareholder is expressed throughout the Internal Revenue Code, particularly in Subchapter C. *E.g.*, I.R.C. §§ 302(b)(3), 306(b)(1) (special exceptions from taxation at ordinary rates for shareholder's interest when interest terminated by redemption or another form of disposition); *id.* § 302(c)(2) (waiver of family attribution rules for distribution in which shareholder's interest in corporation is terminated and no interest is acquired within ten years of distribution), discussed in SEN. COMM. ON FINANCE, REPORT ON INTERNAL REVENUE CODE OF 1954, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4676 ("insur[ing] a bona fide severance of a particular shareholder's interest in an enterprise"); I.R.C. § 303 (distributions to shareholder in redemption of stock to pay federal estate taxes given capital gains treatment), discussed in H.R. REP. NO. 2319, 81st Cong., 2d Sess. (1950), reprinted in 1950-2 C.B. 380, 428 ("[R]emedial action is desirable in order to prevent the enforced sale of the family businesses which are so vital and desirable an element in our system of free private enterprise."); I.R.C. §§ 6166-6166A (provisions for deferral of estate tax payment where estate consists largely of interest in closely held business); *id.* § 6601(j) (special low interest on unpaid taxes of 4% of first \$1 million of closely held business property); see 115 CONG. REC. 37,902 (1969) (colloquy between Senators Aiken and Long) (concerning impact on close corporation recapitalizations of I.R.C. § 305(b)(2) taxation of "disproportionate distributions" at ordinary rates: [T]here is no intention to alter the [tax-free] status of a recapitalization in which, for example, the older stockholders exchange some or all of their common stock for preferred stock and retire from the business while the younger stockholders exchange some or all of their preferred stock for additional common stock and continue to be active in the business.)

24. See *People ex rel. Rudaitis v. Galskis*, 233 Ill. App. 414, 420 (1924) (small corporation's restrictions on stock transfer held reasonable and valid); *In re West Waterway Lumber Co.*, 59 Wash. 2d 310, 317, 367 P.2d 807, 811 (1962) ("[R]estrictions that may pass the test of reasonableness when employed by a small, closely held corporation may be totally without justification if attempted by a large, widely held corporation.")

restriction,<sup>25</sup> the designated transfer or option price,<sup>26</sup> and the intended business purpose.<sup>27</sup> There is, however, no general consensus as to what constitutes a reasonable restraint on alienation.

Underlying this judicial tolerance of restrictive agreements is the policy objective of promoting small businesses.<sup>28</sup> Because ownership and management generally coincide in a close corporation, restrictions on share transferability are essential for the harmonious operation of the business<sup>29</sup> and for its continuity upon the retirement or death of one of the initial associates.<sup>30</sup>

25. See, e.g., *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 542, 141 N.E.2d 812, 816, 161 N.Y.S.2d 418, 423 (1957) ("[W]hat the law condemns is, not a *restriction* on transfer, a provision merely postponing sale during the option period, but an effective *prohibition* against transferability itself.") Courts consider the extent of the restraint on alienation in terms of time as well as degree. See, e.g., *Tracey v. Franklin*, 31 Del. Ch. 477, 484, 67 A.2d 56, 59 (1949) (ten-year restriction on stock transfer was "substantial period" requiring compelling justification).

26. See, e.g., *Security Life & Accident Ins. Co. v. Carlovitz*, 251 Ala. 508, 510, 38 So. 2d 274, 276 (1949) (restriction requiring shareholder to sell stock at book value regardless of reasonable market value is void).

27. See, e.g., *Lawson v. Household Fin. Corp.*, 17 Del. Ch. 343, 352, 152 A. 723, 727 (1930) (restriction upheld because maintenance of closely knit group of shareholders essential to type of business being conducted).

28. See *Groves v. Prickett*, 420 F.2d 1119, 1122 (9th Cir. 1970) ("[B]y-laws restricting a transfer in closed corporations are sometimes essential to a successful enterprise."); *Mather's Estate*, 410 Pa. 361, 369, 189 A.2d 586, 590 (1963) ("[F]amily agreements are always favored in the law . . .").

29. An outside purchaser would have full rights in the management of the business, regardless of any lack of expertise or possible opposition to the basic policies of the existing associates. Transfer agreements are also necessary to prevent competitors from acquiring an interest with the sole intention of undermining the business. For these reasons, Oliver Wendell Holmes in an early Massachusetts case concluded: "[T]here seems to be no greater objection to retaining the right of choosing one's associates in a corporation than in a firm." *Barrett v. King*, 181 Mass. 476, 479, 63 N.E. 934, 935 (1902).

30. There is a real danger that an interest in a close corporation might descend automatically by inheritance to a family member who either is uninterested in the management of the corporation or is concerned only with the investment value of the shares. This inactive shareholder might oppose any corporate retention of earnings, instead preferring payment of dividends.

The recognition of restrictive transfer agreements as determinative of fair market value for estate tax valuation of a closely held business interest promotes the continuance of the business upon the death of one of the shareholder-partners. Because no established market exists for closely held shares, there is a danger that the Internal Revenue Service will overvalue a decedent associate's interest by basing its valuation of property appreciation and goodwill on an overly optimistic view of probable future earnings. Lack of an established market makes undervaluation of a decedent's business interest as likely as overvaluation. The effects of each, however, are not symmetrical due to the fact that overvaluation can potentially force a sale of the business itself. The result may be dissipation of the estate and a forced sale of the business in order to pay estate taxes, or, alternatively, a temporary stoppage of business pending a court challenge of the Service's valuation figure. Automatic acceptance of a restrictive partnership or close corporation agreement as fixing the taxable value of the decedent's interest eliminates time and dollar costs, and hence guarantees uninterrupted business operations. See Matsen,

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Although the courts have, in general, enforced contractually valid restrictive agreements, they have split on the use of such restrictions in determining the fair market value of the interest for federal estate tax purposes. On the one hand, the courts that adopt an intrinsic value standard argue that actual market price is not the sole index of the worth of a closely held or unincorporated business interest, but rather that ownership is a "bundle of rights,"<sup>31</sup> each of which represents value to the owner. They emphasize retention rather than sale value<sup>32</sup> and conclude that a restrictive agreement represents no more than one of many factors to be considered in estate tax appraisal proceedings.<sup>33</sup> On the other hand, the courts that accept a

*Establishing the Price for Closely Held Business Buy-Sell Agreements*, 5 J. CORP. TAX. 134, 136 (1978).

Restrictive agreements serve a number of business purposes in addition to the continuity objective. *See id.* at 136-37 (listing possible purposes for buy-sell agreements). Restrictions may be useful for maintaining Subchapter S status by ensuring that no shareholder can terminate the corporation's eligibility either by transferring shares to a non-qualified holder, for example, a corporation or a trust, or by splitting up his interest and transferring shares to a number of individuals with the result that the total number of the corporation's shareholders exceeds the permissible maximum of 10. *See* 2 F.H. O'NEAL, *supra* note 2, § 7.02, at 7-5; Stinson, *Terminating the Election Under Subchapter S*, 18 N.Y.U. TAX INST. 707, 717 (1960). Avoidance of federal securities regulation may also be facilitated by a restrictive agreement. Such an arrangement permits a close corporation to fall within the non-public offerings exemption of the Securities Act of 1933, thus saving the corporation from the Act's registration requirements. *See* Securities Act of 1933, § 4, 15 U.S.C. § 77d (1976). Finally, a restrictive agreement fixing an employee stock option price may result in a deferral of income tax liability. *Treas. Reg.* § 1.421-6(d)(2), T.D. 6540, 1961-1 C.B. 161, 163-64.

31. Maitland, *The Mystery of Seisin*, 2 LAW Q. REV. 481, 489 (1886) (origin of term). A restriction or even elimination of transferability will depress but not destroy the value of a business interest. A buyer might well be willing to pay more than the stated option price for rights to receive dividends, to vote, and to receive a return upon liquidation, despite restricted transferability of the interest. Thus, a restrictive agreement should be no more than an important factor in estate tax valuation proceedings. *See Note, Valuation of Stock Subject to Restrictive Agreement for Federal Estate and Gift Taxation*, 60 HARV. L. REV. 123, 125 (1946) (value of business interest is not determined solely by its alienability, but is sum of all rights granted to shareholder by original contract between associate and business entity).

32. *See* *United States v. Land*, 303 F.2d 170 (5th Cir.), *cert. denied*, 371 U.S. 862 (1962); *Estate of Reynolds v. Commissioner*, 55 T.C. 172 (1970), *acq.* 1971-2 C.B. 3.

33. The restrictive agreement exception is called off and the factor approach to close corporation stock valuation is called back on. *See* notes 11-13 *supra* (discussing general factors considered in valuation).

In the gift tax context, the intrinsic value definition governs, and restrictive agreements are never conclusive for valuation purposes. *See* *Commissioner v. McCann*, 146 F.2d 385, 386 (2d Cir. 1944); *Rev. Rul.* 189, 1953-2 C.B. 294. The failure of courts to adopt a similar uniform definition of fair market value in the estate tax area can be traced to a perceived distinction between the effect of restrictive agreements in each situation. This was explained well by the court in *Spitzer v. Commissioner*, 153 F.2d 967 (8th Cir. 1946):

[T]he value of the shares and the critical time for the determination of value were fixed by the option contract. In each of the estate tax cases the critical event, the

sales standard of fair market value look to the actual market in which a decedent's business interest can be sold. Because a restrictive agreement limits that market, the fair market value of the interest cannot exceed the sale price stated in the agreement.<sup>34</sup>

The uncertainty resulting from divergent fair market valuation approaches has been compounded by the courts' lack of consistency in determining whether a restrictive agreement is conclusive for estate tax purposes. A variety of requirements have been imposed to differentiate genuine restrictive business contracts from disguised tax avoidance devices. Most commonly, an agreement must satisfy some combination of five tests: validity and enforceability;<sup>35</sup> reasonable, specified, stated or formula price;<sup>36</sup> sufficient restrictions on the transfer of shares during life and at death;<sup>37</sup> underlying bona fide busi-

death of the holder of the shares, which subjected the stock to purchase for a price stated in the option, had occurred . . . . When the gift was made no one could predict when petitioner might die, or retire without the consent of the other executive stockholders. The critical event necessary to occur in order to bring into play the provisions of the contract fixing the price of the stock given by petitioner to his wife had not occurred . . . .

*Id.* at 970-71.

34. The Second Circuit in *Wilson v. Bowers*, 57 F.2d 682 (2d Cir. 1932), first applied the sale standard to examinations of restrictive agreements' impact on estate tax valuation. It held that a contract granting shareholders an option to purchase stock at a certain price upon the lifetime disposition of the owner's stock or at his death fixed the value of the stock for tax purposes at that stated price, because no "willing buyer" would have purchased the stock for more than its stated option value. *Id.* at 683-84. This approach has been followed in a number of estate tax valuation cases. See *May v. McGowan*, 194 F.2d 396 (2d Cir. 1952); *Estate of Littick v. Commissioner*, 31 T.C. 181 (1958), *acq.* 1959-2 C.B. 5; *Estate of Weil v. Commissioner*, 22 T.C. 1267 (1954), *acq.* 1955-2 C.B. 10.

35. See *Brodrick v. Gore*, 224 F.2d 892 (10th Cir. 1955); *Lomb v. Sugden*, 82 F.2d 166 (2d Cir. 1936); *Estate of Hammond v. Commissioner*, 13 T.C.M. (CCH) 903 (1954), *supplemented by* 14 T.C.M. (CCH) 83 (1955).

36. A restrictive agreement must specify either a fixed option price or a method for calculating that price (for example, book value) that is reasonable at the time the agreement was made. See *Estate of Cotchett v. Commissioner*, 33 T.C.M. (CCH) 138, 141 (1974) ("In most situations . . . a right of first refusal without a fixed price will have little, if any, effect on fair market value . . . .") Courts look favorably upon provisions in restrictive agreements for the periodic adjustment of the stated value. See *Estate of Davis*, 37 T.C.M. (CCH) 341, 343 (1978).

37. First-offer restrictions on sale of shares have often been held to be the sole index of the shares' value for estate tax purposes when the restrictions are enforceable both at death and during the shareholder's lifetime. See *May v. McGowan*, 194 F.2d 396, 397 (2d Cir. 1952); *Slocum v. United States*, 256 F. Supp. 753, 755 (S.D.N.Y. 1966). The courts and the Internal Revenue Service have recognized as well the effectiveness of restrictive agreements in which the option is granted to the corporation to repurchase the stock at a fixed price. See *Estate of Salt v. Commissioner*, 17 T.C. 92, 99 (1951), *acq.* 1952-1 C.B. 4. When an agreement fixes the price at death but contains no restriction on the decedent's right to dispose of his property at the best price possible during his lifetime, however, the property is included in the estate at its full fair market value rather than at the stated value. See *Estate of Caplan v. Commissioner*, 33 T.C.M. (CCH) 189, 192 (1974); *Estate of Matthews v. Commissioner*, 3 T.C. 525, 529 (1944), *acq.* 1944 C.B. 19.

A narrow definition of restriction is ordinarily used. For example, when a security may



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ness purpose;<sup>38</sup> and negotiation at arm's length.<sup>39</sup> The first three objective tests have presented few difficulties. The final two standards, on the other hand, by requiring judicial scrutiny of the motivations of the parties creating a restrictive transfer arrangement, have been the source of endless dispute. Inquiries into subjective intent have been particularly difficult in view of the high incidence of intra-family transfers effected by close corporation or partnership agreements.<sup>40</sup>

be freely given or devised even though it would remain subject to the agreement in the hands of the donee, the transfer agreement has been held to be not sufficiently restrictive for tax valuation purposes. The stated value is "at most a factor to be considered." *Estate of Reynolds v. Commissioner*, 55 T.C. 172, 191 (1970), *acq.* 1971-2 C.B. 3. Similarly, when there is no compulsion to sell or absolute option to buy, a restrictive agreement is not determinative. *See Krauss v. United States*, 140 F.2d 510, 511 (5th Cir. 1944).

The requirement of restrictions on transfer both during life and at death is imposed in the partnership context as well. *See United States v. Land*, 303 F.2d 170, 171 (5th Cir. 1962); *Estate of Weil v. Commissioner*, 22 T.C. 1267, 1273-74 (1954), *acq.* 1955-2 C.B. 10; *Hoffman v. Commissioner*, 2 T.C. 1160, 1179 (1943), *aff'd on other grounds sub nom. Giannini v. Commissioner*, 148 F.2d 285 (9th Cir.), *cert. denied*, 326 U.S. 730 (1945).

38. Courts have recognized several valid business purposes for restricting transferability: (1) preservation of control in a close group, *see Slocum v. United States*, 256 F. Supp. 753, 755 (S.D.N.Y. 1966); *Estate of Littick v. Commissioner*, 31 T.C. 181, 187 (1958), *acq.* 1959-2 C.B. 5; (2) maintenance of family ownership and control, *see Estate of Bischoff v. Commissioner*, 69 T.C. 32, 41 (1977); (3) continuity of a partnership after the death of any of the partners, *see Brodrick v. Gore*, 224 F.2d 892, 896-97 (10th Cir. 1955); *Estate of Fiorito v. Commissioner*, 33 T.C. 440, 445 (1959), *acq.* 1960-1 C.B. 4; and (4) insulation of assets from potential liabilities, *see Green Light Co. v. United States*, 405 F.2d 1068, 1071 (5th Cir. 1968); *Estate of Mundy v. Commissioner*, 35 T.C.M. (CCH) 1778, 1793 (1976); *Siegel v. Commissioner*, 45 T.C. 566, 575 (1966).

39. The valuation provisions of a stockholders' agreement will be disregarded if they represent a tax device or are substitutes for a testamentary disposition to the decedent's natural issue. *See Estate of Anderson v. Commissioner*, 36 T.C.M. (CCH) 972, 977 (1977), *aff'd*, 619 F.2d 587 (6th Cir. 1980) (dictum). "While transactions involving a family group should be given special scrutiny, it does not follow that the terms of such transactions should necessarily be disregarded." *Estate of Cotchett v. Commissioner*, 33 T.C.M. (CCH) 138, 142 (1974). In fact, in numerous cases restrictive agreements of family corporations have been recognized as effective for estate tax purposes. *See, e.g., Commissioner v. Bensel*, 100 F.2d 639, 639 (3d Cir. 1938); *Estate of Macdonald v. Commissioner*, 10 T.C.M. (CCH) 1038, 1054 (1951).

Inadequate consideration is the customary indicator of whether or not a transfer or stockholders' agreement has been negotiated at arm's length. A mere gratuitous promise to transfer shares to an individual at a grossly inadequate price will void the close corporation or partnership contract. *Hoffman v. Commissioner*, 2 T.C. 1160, 1179 (1943), *aff'd on other grounds sub nom. Giannini v. Commissioner*, 148 F.2d 285 (9th Cir.), *cert. denied*, 326 U.S. 730 (1945). Other requirements have appeared in the case law, either separately or as subtests under the general rubrics of bona fide business purpose or arm's-length negotiation. These include tax avoidance motives, *see Estate of Caplan v. Commissioner*, 33 T.C.M. (CCH) 189, 191-92 (1974); *Estate of Weil v. Commissioner*, 22 T.C. 1267, 1275 (1954), *acq.* 1955-2 C.B. 10; adequate and full consideration in money or money's worth, *see Estate of Anderson v. Commissioner*, 36 T.C.M. (CCH) 972, 977 (1977), *aff'd*, 619 F.2d 587 (6th Cir. 1980); and reciprocity, *see Estate of Fry v. Commissioner*, 9 T.C. 503, 508-09 (1947), *acq.* 1948-2 C.B. 2.

40. *See Commissioner v. Bensel*, 100 F.2d 639, 639 (3d Cir. 1938); *Estate of Caplan v. Commissioner*, 33 T.C.M. (CCH) 189, 192 (1974); *Estate of Fiorito v. Commissioner*, 33

Thus, current judicial doctrines lack manageability and uniformity. This jurisprudential morass is the inevitable consequence of more than a half century of vague statutory guidelines and Supreme Court failure to prescribe the estate tax treatment of restrictive stock transfer agreements.<sup>41</sup>

## II. Rationale for a New Theory: The Insurance Paradigm

A close corporation or partnership restrictive agreement is, in effect, a form of reciprocal insurance: a number of business associates voluntarily enter into an arrangement whereby they mutually guarantee their investment. Under a reciprocal insurance arrangement, members of a partnership simultaneously take out insurance on each other's lives so that, upon the death of one partner, the others receive funds as compensation for the financial loss sustained by the business as a result of the partner's death. Such an arrangement supplies surviving partners with sufficient financial resources to continue the business in its existing form. Similarly, a close corporation or partnership restrictive agreement insures against disruption of a closely held business upon the death or retirement of a shareholder-partner by restricting transfer of share ownership to other shareholder-partners of the business, by setting a minimum value for the interest, and by guaranteeing a market for its sale. From this parallelism between

T.C. 440, 446 (1959), *acq.* 1960-1 C.B. 4; *Estate of Littick v. Commissioner*, 31 T.C. 181, 188 (1958), *acq.* 1959-2 C.B. 5. See generally Schwingle, *Valuation of a Family Business*, 12 TUL. TAX INST. 231 (1963); Note, *Testamentary Transfers of Family Partnership Interests*, 8 STAN. L. REV. 703 (1956).

41. The Supreme Court has not yet considered any case involving restrictive agreements and estate tax valuation of close corporation or unincorporated business interests. In the income tax context, the Court has held that shares of stock subject to a qualifying option agreement may have no taxable value, *Helvering v. Tex-Penn Co.*, 300 U.S. 481, 499 (1937), and that in no case will that value exceed the repurchase price, *Helvering v. Salvage*, 297 U.S. 106, 109 (1936). In *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), however, the Court decided that the cash surrender price of a single-premium life insurance policy does not fix its value for federal gift tax purposes because "the owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to retain it for its investment virtues and to receive the face amount of the policy upon the insured's death." *Id.* at 257.

In contrast, the Court in *United States v. Cartwright*, 411 U.S. 546 (1973), emphasized the sale rather than the retention value of mutual fund shares. Analogizing the case to those involving restricted close corporation stock, Justice White concluded that the value of mutual fund shares could not exceed the contractual redemption price. *Id.* at 554. See generally Epstein, *Estate Tax Valuation of Mutual Fund Shares: An Unrealistic Regulation*, 24 HASTINGS L.J. 241 (1973); Lauro, *Cartwright v. U.S.: The Clear Ring of Common Sense*, 49 NOTRE DAME LAW. 643 (1974); Wilkins, *The Supreme Court's Cartwright Decision: Does It Signal New Valuation Disputes?* 39 J. TAX. 2 (1973).

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restrictive agreements and reciprocal insurance, a test for federal estate tax treatment of restrictive agreements can be constructed.

Reciprocal insurance arrangements are void unless each party has an insurable interest in the lives of the others.<sup>42</sup> To be valid, insurance agreements must be intended to compensate the survivor for some pecuniary loss, rather than reward him for longevity.<sup>43</sup> Under the rules of the present Code, a decedent's gross estate does not include the proceeds of insurance policies on his life unless he retained at the time of his death certain specified "incidents of ownership."<sup>44</sup> All proceeds of reciprocal policies in which the decedent held incidents of ownership are included in his gross estate. If no incidents were retained, only the value of his unmatured policies on other parties is taxable.<sup>45</sup>

42. See *Ducros v. Commissioner*, 272 F.2d 49, 51 (6th Cir. 1959); *Harrison v. Commissioner*, 59 T.C. 578, 585 (1973); *Goedel v. Commissioner*, 39 B.T.A. 1, 10 (1939).

43. A tontine, under which a number of individuals procure insurance on each other's lives with the understanding that survivors "take all," is tantamount to a wagering or gambling contract and is unenforceable for public policy reasons. In the classic case of *Connecticut Mut. Life Ins. Co. v. Schaefer*, 94 U.S. 457 (1876), the Supreme Court held that:

[a] man cannot take out insurance on the life of a total stranger, nor on that of one who is not so connected with him as to make the continuance of the life a matter of some real interest to him . . . [I]t may be said generally that any reasonable expectation of pecuniary benefit or advantage from the continued life of another creates an insurable interest in such life.

*Id.* at 460; see *Colgrove v. Lowe*, 343 Ill. 360, 363, 175 N.E. 569, 571 (1931), *cert. denied*, 284 U.S. 639 (1931) ("[I]t has been uniformly held that a contract of insurance upon a life in which the insurer has no interest is a pure wager, that gives the insurer a sinister counter-interest in having the life come to an end . . ."); *Adam Míguez Funeral Home, Inc. v. First Nat'l Life Ins. Co.*, 234 So. 2d 496, 499 (La. Ct. App. 1970) (*dictum*).

44. The term "incidents of ownership" includes a reversionary interest in a life insurance policy that exceeds five percent of the value of the policy immediately before the death of the decedent. I.R.C. § 2042(2). It also refers to the right of the insured or his estate to the economic benefits of the policy. "[I]t includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy." *Treas. Reg. § 20.2042-1(c)(2)*, T.D. 7312, 1974-1 C.B. 277, 278.

If no incidents are in the decedent's possession at death and if the proceeds of the policy are not receivable by the decedent's executor, there is no tax. I.R.C. § 2042; *Treas. Reg. § 20.2042-1(c)(1)* (1958); see *Commissioner v. Noel's Estate*, 380 U.S. 678, 684 (1965) (*dictum*).

45. Insurance held by a decedent on the life of another is subject to estate taxation under I.R.C. § 2033 as property in which the decedent possessed an interest at the time of his death. Such policies are taxed at replacement cost, or in the event that they cannot be replaced, in the amount of the interpolated terminal reserve. *Estate of DuPont v. Commissioner*, 233 F.2d 210, 212 (3d Cir.), *cert. denied*, 352 U.S. 878 (1956). In the case of reciprocal insurance arrangements, however, in which parties simultaneously insure each other's lives, the law is not yet settled as to whether the separate insurance contracts should be disregarded and the proceeds received by the insurers-beneficiaries included in the insured decedent's gross estate under the reciprocal trust rule.

The reciprocal trust doctrine originated in *Lehman v. Commissioner*, 109 F.2d 99 (2d Cir.), *cert. denied*, 310 U.S. 637 (1940), which held a decedent's estate liable for

The Code makes a series of special exceptions for cases involving reciprocal insurance arrangements intended for the purchase of a decedent's closely held or partnership interest subject to a restrictive agreement. The issues presented for consideration by revenue collectors and courts are the validity of the insurance contract under state law, the existence of any ancillary binding and enforceable buy-sell or option arrangements,<sup>46</sup> and the terms of the insurance contract. Once the validity of the insurance and restrictive agreements is established, federal estate tax treatment of reciprocal insurance contracts is governed by clearly delineated standards that focus on the contract format and the recipient of insurance proceeds.

If the proceeds are payable to the decedent's estate for the purchase of the decedent's closely held or partnership interest, the proceeds are included in the gross estate. The value of the business interest is also includable at an amount equal to its stated value less insurance proceeds.<sup>47</sup> However, if the decedent at his death retains incidents of ownership in the insurance policy, and the proceeds are intended to replace further payment to the decedent for his business interest, only the value of the proceeds is includable.<sup>48</sup>

tax on a trust created by decedent for his brother's benefit as a quid pro quo for the brother's establishment of a trust for decedent's benefit. The court remarked that "[t]he fact that the trusts were reciprocated or 'crossed' is a trifle, quite lacking in practical or legal significance." *Id.* at 100. The *Lehman* standard has been followed extensively. *See, e.g.,* Hanauer's Estate v. Commissioner, 149 F.2d 857, 858 (2d Cir.), *cert. denied*, 326 U.S. 770 (1945); Cole's Estate v. Commissioner, 140 F.2d 636, 637-38 (8th Cir. 1944).

The Supreme Court finally considered the issue in the case of *United States v. Estate of Grace*, 395 U.S. 316 (1969). Justice Marshall developed a new test to determine the validity of reciprocal trusts for estate tax purposes. Rejecting the former standards of tax avoidance motive and quid pro quo consideration, Justice Marshall held that "application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries." *Id.* at 324. In an unfortunate footnote to the opinion, however, Justice Marshall stated that the traditional definition of consideration as a "bargained-for exchange" remained relevant under the new test: "In certain cases, inquiries into the settlor's reasons for creating the trusts may be helpful in establishing the requisite link between the two trusts." *Id.* at 324 n.10. *See generally* Berge, *United States v. Estate of Grace: The Reincarnation of the Reciprocal Trust Doctrine*, 17 U.C.L.A. L. REV. 436 (1969); Ledden, *Reciprocal Trusts: Consideration No Longer The Cornerstone of Taxability—United States v. Estate of Grace*, 395 U.S. 316, 21 SYRACUSE L. REV. 357 (1969).

46. If the restrictive agreement is not enforceable or sufficiently restrictive, the reciprocal insurance arrangement will not be given special estate tax treatment. *See* *Estate of Matthews v. Commissioner*, 3 T.C. 525, 529 (1944); Rev. Rul. 54-77, 1954-1 C.B. 187; Rev. Rul. 157, 1953-2 C.B. 255.

47. *See* *Estate of Tompkins v. Commissioner*, 13 T.C. 1054, 1058 (1949), *acq.* 1950-1 C.B. 5; *Estate of Mitchell v. Commissioner*, 37 B.T.A. 1, 6 (1937), *acq.* 1938-1 C.B. 20.

48. *See* S. SURREY, W. WARREN, P. MCDANIEL, & H. GUTMAN, *FEDERAL WEALTH TRANSFER TAXATION* 606 (1977).

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If the proceeds are payable to the survivor for purchase of the decedent's interest, the proceeds are not includable in the decedent's gross estate. The value of the business interest is includable at its stated value.<sup>49</sup> This is the rule even in cases in which powers are retained by the decedent pursuant to the reciprocal insurance arrangements, provided that the powers are incident to funding a restrictive agreement for the purchase of a business associate's interest.<sup>50</sup> The reciprocal trust rule does not apply.<sup>51</sup>

If the proceeds are payable to the business entity for its purchase of a decedent associate's business interest pursuant to a restrictive agreement and no incidents of ownership in the insurance policy are retained by the decedent, the proceeds are not includable in the decedent's gross estate. The value of the interest is includable in the estate at its stated value.<sup>52</sup> Even when the business entity procures insurance on the lives of its shareholder-partners for a purpose other than the funding of a restrictive entity-purchase contract, the proceeds usually are not includable in the decedent's estate if the decedent retains no incidents of ownership.<sup>53</sup> However, when the entity purchases insurance for the acquisition of a deceased associate's interest by other stockholder-partners rather than by the entity itself, the proceeds are not a general business asset and accordingly are includable in the decedent's gross estate.<sup>54</sup>

This treatment of reciprocal insurance contracts provides a basis for reform of the current procedure for estate tax valuation of re-

49. See *Estate of Ealy v. Commissioner*, 10 T.C.M. (CCH) 431, 433 (1951); *Estate of Riecker v. Commissioner*, 3 T.C.M. (CCH) 1293, 1296 (1944).

50. See *Estate of Infante v. Commissioner*, 29 T.C.M. (CCH) 903, 907 (1970), *appeal dismissed*, [1971 Transfer Binder] FED. TAXES (P-H) ¶ 101,201 (7th Cir. 1971); *Estate of Fuchs v. Commissioner*, 47 T.C. 199, 206 (1966), *acq.* 1967-2 C.B. 2; *Estate of Weil v. Commissioner*, 22 T.C. 1267, 1275 (1954), *acq.* 1955-2 C.B. 10.

51. [W]here a business associate purchased a policy of insurance on the life of the decedent for the purpose of purchasing the latter's share in the business enterprise, naming himself, his executors, administrators, or assigns as beneficiary, paying all premiums thereon and retaining all the incidents of ownership therein until the decedent's death, the proceeds thereof are not includible in the decedent's gross estate even though, at the same time and for the same purpose, the decedent may have purchased a similar policy of insurance on the life of the business associate. Rev. Rul. 56-397, 1956-2 C.B. 599, 600.

52. See *Estate of Knipp v. Commissioner*, 25 T.C. 153, 168 (1956), *aff'd*, 244 F.2d 436 (4th Cir. 1957), *acq.* 1959-1 C.B. 4.

53. I.R.C. § 2042(2) ("key-man insurance" not includable if decedent possessed no incidents of ownership). This does not apply if the decedent was a controlling stockholder and the insurance proceeds were not received for the benefit of the corporation. Treas. Reg. § 20.2042-1(c)(6), T.D. 7312, 1974-1 C.B. 277, 278.

54. The proceeds are includable in decedent's gross estate because the corporation has purchased the insurance to meet a personal obligation of the decedent. Treas. Reg. § 20.2042-1(b)(1) (1958).

stricted close corporation and partnership interests. Because of the intrinsic insurance attributes of restrictive agreements, an appropriate determinant of an agreement's effect for federal estate tax purposes is its conformity to the reciprocal insurance paradigm. A requirement of an insurable pecuniary interest modeled on the existing standards for testing the insurable interests of partners, combined with inquiries into the contractual and the factual circumstances surrounding its formation, could be touchstones for granting an agreement conclusive estate tax effect or for relegating it to the position of one of many factors<sup>55</sup> considered by federal tax authorities and the courts in the valuation of a close corporation or partnership interest.

A significant difference between restrictive agreements and their reciprocal insurance counterparts, however, must be kept in mind—the former contain no explicit provisions for payment of premiums. Consequently, restrictive agreements should be scrutinized individually to ensure implicit correspondence with the reciprocal insurance model. In this way, the objective insurance approach could be adopted for restrictive agreements without creating a loophole for significant tax avoidance.

### III. The Proposed Reciprocal Insurance Standard

The proposed restrictive agreement standard would require rules to determine in specific cases whether an agreement is appropriate for preferential estate tax treatment. This Note proposes a three-part test based upon the Code's treatment of reciprocal insurance policies. Under the proposed test, a restrictive agreement would have a conclusive effect on estate tax valuation if three criteria were met: the agreement is enforceable and restrictive, the parties to the agreement have mutual insurable business interests, and the net effect of the agreement is that each party's relative economic position is virtually unchanged. This test should be adopted either as a clarifying amendment to the current regulations or as an addition to the Code itself.

55. See notes 11-13 *supra* (discussing valuation techniques). The reciprocal insurance analogy could be useful even in the context of restrictive agreements that are not eligible for determinative estate tax valuation effect. It is possible to view all restrictive agreements as containing some insurance component. An evaluator could conceivably divide out this insurance part and give it special recognition while treating the remaining part under the current system for valuation and estate taxation. This procedure, however, although the logical consequence of the reciprocal insurance analogy, would probably be unmanageable by federal tax authorities and courts.

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### A. *Enforceable and Binding Agreement*

The first requirement of the test would coincide with that developed under existing law. The agreement must be valid and enforceable under local state law,<sup>56</sup> and the share restrictions binding on all business associates. Any provision for free alienability of the interest during the parties' lifetime or at death would undermine the fundamental objectives underlying the restrictive agreement exception. No favored succession arrangement exists in cases in which a decedent party's estate can dispose of his interest without restriction as to buyer or sale price.<sup>57</sup> Similarly, if lifetime transferability is unlimited, the agreement is a purely testamentary document<sup>58</sup> and does not serve the business purpose envisioned—promoting harmonious operation of a closely held business by impeding the entry of outsiders.

### B. *Mutual Insurable Business Interests*

In order to prevent the use of the restrictive agreement form for tax-free testamentary transfers, the proposed standard would require that stockholder-partners have insurable business interests in the lives of other stockholder-partners. This approach would avoid the subjective examination of the parties' motives that is necessary under the current requirement that all such arrangements be reached by arm's-length negotiation for bona fide business purposes.<sup>59</sup> No restrictive agreement should be accorded conclusive effect for estate tax valuation purposes unless the decedent's estate proves a sufficient interlocking business relationship between the decedent and other parties to the agreement.

Most jurisdictions require that the insuring partners or partnership have an insurable interest in the insured members of the firm.<sup>60</sup>

56. See *Brodrick v. Gore*, 224 F.2d 892 (10th Cir. 1955) (restrictive agreements must be valid and enforceable); *Estate of Hammond v. Commissioner*, 13 T.C.M. (CCH) 903 (1954), supplemented by 14 T.C.M. (CCH) 83 (1955) (same).

57. See note 36 *supra* (restrictive agreements must specify price).

58. See note 37 *supra* (restrictions required on transfers both during life and at death).

59. See p. 871 *supra* (discussing difficulty of inquiries into subjective intent). In *United States v. Estate of Grace*, 395 U.S. 316 (1969), the Court discussed the inherent difficulties associated with family transfers:

[I]nquiries into subjective intent, especially in intrafamily transfers, are particularly perilous . . . . [I]t is unrealistic to assume that the settlors of the trusts, usually members of one family unit, will have created their trusts as a bargained-for exchange for the other trust. "Consideration," in the traditional legal sense, simply does not normally enter into such intrafamily transfers.

*Id.* at 323-24.

60. See *Connecticut Mut. Life Ins. Co. v. Luchs*, 108 U.S. 498, 505 (1883); *Poland v. Estate of Fisher*, 329 S.W.2d 768, 772 (Mo. 1959); *Lakin v. Postal Life & Cas. Ins. Co.*, 316 S.W.2d 542, 549 (Mo. 1958).

An insurable business interest is not automatically presumed from the mere existence of a partnership relationship. The burden is placed on the parties to show that the "business relationships . . . [are] interlocked and intertwined and . . . for their mutual prosperity, [and that] they [are] mutually dependent upon each other."<sup>61</sup> An insurable interest has been found in cases in which the insured partner has furnished capital for the partnership,<sup>62</sup> contributed management skills<sup>63</sup> or technical "know-how,"<sup>64</sup> or is under a contractual obligation to provide future capital or services.<sup>65</sup> No insurable interest exists if the insuring partner would gain more pecuniary benefit from the death of the insured than from his continuing participation in the partnership.<sup>66</sup>

Under a restrictive agreement, the survivors acquire an increased share in the business upon the death of an associate. Therefore, to satisfy the business relationship-insurable interest test it must be shown that the pecuniary loss suffered by the decedent's associates as a result

61. *Butterworth v. Mississippi Valley Trust Co.*, 240 S.W.2d 676, 680 (Mo. 1951).

62. *See Connecticut Mut. Life Ins. Co. v. Luchs*, 108 U.S. 498, 505-06 (1883); *Cooper's Adm'r v. Lebus' Adm'rs*, 262 Ky. 245, 250, 90 S.W.2d 33, 36 (1935).

63. *See Rush v. Howkins*, 135 Ga. 128, 128, 68 S.E. 1035, 1035 (1910); *Travelers Ins. Co. v. Morris*, 115 N.J. Eq. 142, 144-45, 169 A. 835, 836 (1934).

64. *See Indemnity Ins. Co. of N. America v. Dow*, 174 F.2d 168, 170 (6th Cir. 1949); *Ruth v. Flynn*, 26 Colo. App. 171, 181, 142 P. 194, 197 (1914).

65. *See Bevin v. Connecticut Mut. Life Ins. Co.*, 23 Conn. 244, 251-52 (1854). Similar objective standards have been applied in determining the validity of family partnerships for income tax purposes. In two early Supreme Court decisions, *Commissioner v. Tower*, 327 U.S. 280 (1946), and *Lusthaus v. Commissioner*, 327 U.S. 293 (1946), two tests of partnership were developed—capital or services contribution by each partner:

There can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other, purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things she may be a partner . . . . But when she does not share in the management and control of the business, contributes no vital additional service, and where the husband purports in some way to have given her a partnership interest, the Tax Court may properly take these circumstances into consideration in determining whether the partnership is real within the meaning of the federal revenue laws.

*Commissioner v. Tower*, 327 U.S. at 290.

In *Commissioner v. Culbertson*, 337 U.S. 733 (1949), the Supreme Court reinterpreted the *Tower* and *Lusthaus* decisions, giving them a more subjective gloss: "The question is . . . whether, considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Id.* at 742; *see Lichter v. Commissioner*, 17 T.C. 1111, 1117 (1952); Beck, *Use of the Family Partnership as an Operating Device—The New Regulations*, 12 N.Y.U. TAX INST. 603, 605-06 (1954); Comment, *Family Partnerships and the Revenue Act of 1951*, 61 YALE L.J. 541, 543 (1952).

66. "The element of wager . . . could serve to deny the right of the partners to a reciprocal insurable interest . . . [because] a partner's expectation of benefit or advantage could lie not in the continuance of the lives of his partners but rather in the possibility of their deaths prior to his own." *Block v. Mylish*, 351 Pa. 611, 618, 41 A.2d 731, 735 (1945).



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of his death is not exceeded by the benefits accruing from the restrictive agreement. The executor must demonstrate that the decedent and survivors-beneficiaries of the restrictive agreement had a mutual financial insurable interest in each other's lives; that is, they had contributed, or were under a legal obligation to contribute, capital, services, or technical expertise to the business association.<sup>67</sup>

### C. *Net Economic Effect*

In the insurance context, a reciprocal arrangement is valid whenever the insurance contract terms are legally binding and the parties' insurable business interests are mutual. As a result of the contract, each party acquires a right to future insurance proceeds, contingent upon his survival. The relative position of each party is unaltered by the agreement because any health or age discrepancies are equalized by differences in the actuarially determined premium payments.

No such adjustment occurs in a restrictive agreement. Although each business associate may have an insurable interest in his fellow associates, the quantum of that interest may vary significantly. There is no guarantee that the provisions of the arrangement will have a similar impact on all parties. Consequently, in order for the restrictive agreement to have binding effect for estate tax valuation, the proposed standard should require that the agreement not alter the relative financial positions of the parties.<sup>68</sup>

Under this third criterion, the burden would be on the decedent's estate to prove that any increased likelihood of a party's survival—computed actuarially on the basis of such factors as age and health—is compensated by an increased contribution of capital or services to the business association.<sup>69</sup> Any enhanced satisfaction to a party who,

67. Contracts for future services or capital represent potential tax avoidance devices and, as such, must be carefully examined before recognition is granted to a restrictive agreement. Federal tax authorities and courts must consider all objective evidence in order to distinguish genuine business commitments from sham contracts.

68. In effect, the second "economic value" requirement of the reciprocal trust rule established in *United States v. Estate of Grace*, 395 U.S. 316 (1969), is transferred to the restrictive agreement context. The first "interrelatedness" test is discarded because of its potential subjectivity. See note 45 *supra* (discussing *Grace* rule).

69. It should be emphasized that this is not a "consideration" test, but one based on the concept of insurance premiums. Consideration for estate tax purposes usually includes a subjective element. The common statement of the test is "adequate and full consideration in money or money's worth." *Treas. Reg. § 20.2031-2(h)* (1958). Arm's-length dealings and bona fides are integral components of the consideration test. Here, however, all evidence of subjective factors is irrelevant and precluded from consideration by revenue collectors and courts. This is in direct contrast with the approach outlined in *United States v. Estate of Grace*, 395 U.S. 316, 324 n.10 (1969). See note 45 *supra* (discussing *Grace* approach).

because of his advanced age or majority interest in the business, is particularly concerned with preventing entry of outsiders into the firm and settling the succession issue, should be excluded from the evaluation of net economic effect.

#### IV. Application of the Reciprocal Insurance Standard

Taxpayer ingenuity has converted the Code's special protective provisions for closely held businesses into widespread estate tax dodges—most commonly through restrictive agreements and recapitalizations. The courts have found it difficult to distinguish valid restrictive arrangements from mere tax avoidance devices, particularly in cases in which there is an age or health discrepancy or familial relationship between the parties, or in which a preferred stock recapitalization has been undertaken. Application of the proposed standard to each of these troublesome problems demonstrates its implementation of the fundamental Code objectives of promoting succession arrangements in closely held businesses and minimizing tax avoidance by a manageable and objective test.

##### A. *Application to Leading Cases*

Judicial difficulties in determining the estate tax status of restrictive agreements fall into three general, overlapping categories. The problems typified by *Estate of Macdonald v. Commissioner*,<sup>70</sup> *Estate of Littick v. Commissioner*,<sup>71</sup> and *Commissioner v. Bense*<sup>72</sup> provide excellent illustrations for the practical application of the proposed reciprocal insurance standard.

##### 1. *Age Discrepancy*

Courts are often called upon to decide the estate tax effect of restrictive arrangements among parties of disparate ages. In *Estate of Macdonald v. Commissioner*,<sup>73</sup> a healthy seventy-six year old man entered into a stock option contract with his twenty-nine year old grandson. The Tax Court, basing its judgment on evidence of intense and prolonged bargaining, recognized the transfer arrangement as bona fide, free of donative intent, and negotiated at arm's length.<sup>74</sup>

Under the new standard, the first question would be whether the

70. *Estate of Macdonald v. Commissioner*, 10 T.C.M. (CCH) 1038 (1951).

71. *Estate of Littick v. Commissioner*, 31 T.C. 181 (1958), *acq.* 1959-2 C.B. 5.

72. *Commissioner v. Bense*, 36 B.T.A. 246 (1937), *aff'd*, 100 F.2d 639 (3d Cir. 1938).

73. *Estate of Macdonald v. Commissioner*, 10 T.C.M. (CCH) 1038 (1951).

74. *Id.* at 1052-53.

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contract is valid and enforceable under local state law and sufficiently restrictive as to lifetime and death transfers. Because this test is identical to that existing under current law, the *Macdonald* court's analysis and conclusion that the contract met all local requirements would also be appropriate under the proposed standard.

The executor would then be required to demonstrate that the parties had insurable business interests in each other's lives. The exact employment status of the optioner and optionee, and any previous or promised capital contributions to the business, would be relevant. The facts of this case indicate that such an insurable business relationship existed between Macdonald and his grandson. The former owned the publication business and had worked many years in the trade publication field.<sup>75</sup> After the agreement Macdonald intended to retain a significant voice in the company's management and to continue to contribute his demonstrated expertise.<sup>76</sup> The grandson's contribution to the business included five years of training, eight years of employment, and a contractual commitment of future capital and services.<sup>77</sup>

The third requirement, that there be a substantially identical net economic effect on the parties, would be a significant hurdle. Insofar as there is a large age differential involved in a *Macdonald*-type case, it is improbable that the decedent's executor could demonstrate that the quantum of services or capital legally promised to the business by the younger associate offsets the older associate's likely short-term option concession. Examination of the available facts suggests, however, that *Macdonald* might be one of the few cases to satisfy the net economic effect test. The grandson was judged a key employee and had spent all of his adult life in the company's service. Moreover, to secure the option, he had made a legally binding commitment of future services and capital amounting to \$33,000 to be paid over a short period of time.<sup>78</sup> Given the forty-seven year age difference between the optioner and optionee, however, more evidence would be required before the *Macdonald* agreement could be granted determinative estate tax valuation status.

### 2. Health Discrepancy

When one of the parties to a restrictive agreement is in poor health, courts find it difficult to decide whether or not the agreement is en-

75. *Id.* at 1039.

76. *Id.* at 1053.

77. *Id.* at 1040, 1052.

78. *Id.* at 1052.

titled to estate tax recognition. In *Estate of Littick v. Commissioner*,<sup>79</sup> an incurably ill man entered into a close corporation restrictive agreement with his two brothers. The agreement provided that upon the death of any of the brothers, the corporation would buy out the deceased brother's interest at a fixed price. The court held that this arrangement was enforceable for estate tax valuation purposes because, although "it was likely that Orville would die before his brothers, . . . [it] was not a foregone conclusion and [his likely death] is not such a fact as should destroy the validity of the agreement with his brothers."<sup>80</sup>

Unlike the analysis of this decision, the new model would not focus on the possible testamentary motivation of the decedent. Instead, as in the age cases, the proposed standard would test the validity of the agreement and would require a showing of mutual pecuniary interest among the decedent and his business associates. The agreement in the *Littick* case would satisfy these two tests. The court judged the arrangement to be valid, enforceable, and sufficiently restrictive.<sup>81</sup> In addition, the evidence indicates that all three brothers had substantially equivalent interests in the family-held close corporation.<sup>82</sup>

The third criterion of the proposed standard, the net economic effect test, would be a virtually insurmountable obstacle to recognition in an impending death case—it would be highly unlikely, but not impossible, that the executor of a decedent's estate could prove sufficient counterbalancing business contributions or obligations to justify recognition of an agreement that, when made, would be imminently consummated. This rigid test would not be met under the facts of *Littick*. *Littick* contains no evidence that the healthy brothers promised sufficiently greater services or capital to the corporation to account for the substantial likelihood that they would survive Orville. Accordingly, the *Littick* restrictive agreement would be considered inappropriate for preferential estate tax treatment, and the decedent's interest would be valued under the current Code's valuation system.<sup>83</sup>

### 3. *Intrafamily Transactions*

The most prevalent abuses of the restrictive agreement exception occur in the familial context. In the prototypical case, a father enters

79. *Estate of Littick v. Commissioner*, 31 T.C. 181 (1958), *acq.* 1959-2 C.B. 5.

80. *Id.* at 188.

81. *Id.* at 185-87.

82. *Id.* at 182.

83. *See* p. 865 *supra* (discussing valuation on basis of all relevant factors).

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into a restrictive transfer arrangement with his son<sup>84</sup> for the sole purpose of transmitting, at reduced estate tax rates, substantial amounts of wealth in the guise of a closely held business interest. In such cases there may be no intention of passing on the business to the son as a fellow business associate, or even of continuing the business after the father's death. In this way, the taxpayer gains all the tax advantages of restrictive agreement recognition without the business purpose justification for such special estate tax treatment. The following two examples illustrate the treatment of such agreements under the proposed standard.<sup>85</sup>

In *Commissioner v. Bensel*,<sup>86</sup> the majority owner of stock in a close corporation entered into a restrictive transfer agreement with his son, a highly priced executive in the company. The court held that the contractual stated value, rather than the full value, of the father's shares was the proper amount to be included in the decedent's gross estate for estate tax purposes. It based its decision on the arm's-length nature of the agreement, as evidenced by the hostility between father and son, employment of legal counsel, and protracted negotiations preceding the agreement.<sup>87</sup>

Although under the new reciprocal insurance standard the result would be identical, there would be no special scrutiny of the contract by virtue of the propinquity of the parties as occurs under the current standard.<sup>88</sup> The decedent's estate would have to establish that there existed an insurable pecuniary interest between the optioner and optionee, and that the transferred rights under the restrictive

84. Although the most common case of a restrictive agreement between family members is that between father and child, other popular variants are arrangements between siblings, *see, e.g.*, *Hoffman v. Commissioner*, 2 T.C. 1160 (1943), *aff'd on other grounds sub nom. Giannini v. Commissioner*, 148 F.2d 285 (9th Cir.), *cert. denied*, 326 U.S. 730 (1945); *Estate of Littick v. Commissioner*, 31 T.C. 181 (1958), *acq.* 1959-2 C.B. 5, between grandfather and grandchild, *see, e.g.*, *Estate of Macdonald v. Commissioner*, 10 T.C.M. (CCH) 1038 (1951), and between husband and wife, *see, e.g.*, *Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977); *Estate of Trammell v. Commissioner*, 18 T.C. 662 (1952), *acq.* 1953-1 C.B. 6.

85. This Note recognizes the possible validity of family-owned and controlled partnerships and corporations, rejecting suggestions that such business associations, because of their family nature, should be subject to a rebuttable presumption of invalidity for estate tax purposes. *See* ALI FEDERAL ESTATE AND GIFT TAXATION, RECOMMENDATIONS ADOPTED BY THE ALI AND REPORTERS STUDIES 157 (1969). Under the reciprocal insurance standard, restrictive agreements among family members would be accorded the same effect as those among unrelated parties, provided only that they met the requisite criteria for conclusiveness.

86. *Commissioner v. Bensel*, 36 B.T.A. 246 (1937), *aff'd*, 100 F.2d 639 (3d Cir. 1938).

87. *Id.* at 249, 253.

88. *See* note 39 *supra*.

agreement left the parties' relative financial positions unchanged.<sup>89</sup> The *Bensel* case would meet these tests easily. The contributions of capital and services to the business by the father and son, respectively, established mutual insurable business interests. Any age differential between the parties<sup>90</sup> was accounted for by the son's future commitment of his recognized expert services to the company.

On the other hand, a case based loosely on the facts of *Commissioner v. Tower*<sup>91</sup> might reach a different result. In this example, a man enters into a partnership agreement with his wife whereby upon death or retirement, the partnership interest of each is transferable only to the other at an agreed-upon price. The contract is valid, enforceable, and binding both during life and at death. The parties have approximately equivalent life expectancies and are both in good health.

Under existing law, a determination of the agreement's status for estate tax purposes would hinge on the court's view of the subjective intent of the parties in entering into such an arrangement. Because of the marital relationship between the partners, the bona fides and arm's-length tests would be a significant barrier to recognition.<sup>92</sup> Under the new standard, however, because of the approved contract format and the parties' equal likelihood of survival, the decisive test would be whether the parties had mutual insurable business interests. Thus, only if the husband and wife were found to have contributed substantially identical resources to the business in the form of capital, participation in the management and control of the business, expertise, or other vital services would the partnership agreement be recognized for estate tax valuation purposes.<sup>93</sup>

89. *United States v. Estate of Grace*, 395 U.S. 316, 325 (1969). As in the income tax partnership cases, there should be rigid insistence that all capital or services contributed to the business entity be directly traceable to the party in question. *See* note 65 *supra* (discussing capital or services contribution requirement). For example, a restrictive agreement should not be conclusive for estate tax purposes if one party to the agreement has made a gift of capital contribution to the other party; otherwise, the requirement of mutual insurable business interest would become ineffective.

90. *See* pp. 880-81 *supra* (age discrepancy problem).

91. *Commissioner v. Tower*, 327 U.S. 280 (1946).

92. For many courts, as for the court in *Commissioner v. Bensel*, 36 B.T.A. 246 (1937), *aff'd*, 100 F.2d 639 (3d Cir. 1938), it would be necessary to produce evidence of marked hostility between the parties, negotiations through counsel, and unequivocal commitment of both husband and wife to the joint business. *See* p. 883 *supra* (discussing *Bensel* decision).

93. If the business association turned out, however, under the objective tests to be a "dummy partnership" to which one party contributed only funds derived from the other, was not in the employ of the business, or had no voice in managerial decisions, the agreement generally would be disregarded in valuation proceedings as a tax avoidance device.

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### B. *Application to the Problem of Preferred Stock Recapitalizations*

The restrictive agreement form is only one of many taxpayer schemes for circumventing federal estate taxation in the closely held business context. Some of the most prevalent techniques for testamentary disposition of assets at reduced estate tax rates are those that divert the value of future corporate growth to specified individuals (commonly the natural objects of the transferor's bounty) without any loss of control. The favored tax avoidance device for achieving this result is the preferred stock recapitalization, which has become "as standard as the marital deduction when the proper situation presents itself."<sup>94</sup>

In the typical preferred stock recapitalization avoidance scheme, the founder and majority holder of the single class of common stock of a close corporation undertakes a tax-free recapitalization<sup>95</sup> in which the company cancels its common stock and issues in its place a combination of new redeemable preferred stock and common stock. The two classes of stock are issued in such proportions as to ensure that the preferred stock dominates the vote. The preferred stock has an aggregate value approximating the corporation's value at the time of the recapitalization and is divided among the shareholders according to their prior holdings. The new common stock has negligible current value and is issued to all other shareholders, including the founder's donees. As a result of the transaction, the founder retains voting control and receives preferred stock and the right to its dividends, while the other shareholders acquire all rights to the future value of the corporation through their ownership of the common stock. Similar results can be obtained by the use of variations on this model.<sup>96</sup>

94. Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 176 (1977).

95. This can be effected either as a tax-free reorganization of the company pursuant to I.R.C. § 368(a)(1)(E), or as a stock dividend pursuant to I.R.C. § 305. The leading case in this infrequently litigated area is *Estate of Salsbury v. Commissioner*, 34 T.C.M. (CCH) 1441 (1975). For discussions of the preferred stock recapitalization device, see Abrams & Morgan, *Tax Benefits of Recapitalizing a Closely-Held Corporation*, PRACTISING LAW., Sept. 1, 1979, at 11; Ehrlich, *Corporate Recapitalization as an Estate Planning Business Retention Tool*, 34 N.Y.U. TAX INSTR. 1661 (1976); Weinberg, *Using Preferred Stock to Solve Close Corporation Continuity Problems*, 31 J. TAX. 46 (1969); and Williams, *Using a Recapitalization to Reallocate Equity Interests and Perpetuate Closely Held Status*, 32 N.Y.U. TAX INSTR. 715 (1974).

96. There are two related popular variations on the basic preferred stock recapitalization model. By using a similar dual stock structure in a new business venture, see Cooper, *supra* note 94, at 176; Kurzman, *Estate Planning Considerations on the Organization of a Business*, 34 N.Y.U. TAX INSTR. 1433, 1461-62 (1976), the founder of a business can divert from the outset a significant portion of the value of business growth to his heirs. Under another approach, an individual's close corporation stock can be transferred to a

No gift tax is due<sup>97</sup> as a result of the transaction, and an estate tax can be levied only on the value of the founder's limited preferred stock interest.<sup>98</sup> Thus, the closely held business interest is transferred with little or no gift and estate tax effect.

The foregoing scheme and variations on it are generally accepted by tax authorities and courts as valid business means for promoting continuity in closely held businesses.<sup>99</sup> If such purported succession

newly created holding company possessing the desired dual stock structure. See Borini, *The Personal Holding Company as an Estate Planning Tool*, 26 U. S. CAL. TAX INST. 143, 149-50 (1974); Brennan, *The Holding Company: A Creative Estate Planning Tool*, 114 TRUSTS & EST. 716, 716-17 (1975); Oshins & Segal, *Freezing Asset Values Need Not Result in Loss of Control of Business*, 6 EST. PLAN. 322, 323 (1979). This is an invaluable estate planning tool when, because of the presence of outside shareholders or other technical problems, recapitalization of an operating company is not feasible. It should be noted, however, that despite the estate tax advantages of such an arrangement, the newly created personal holding company will be subject to the stringent income tax rules set forth in I.R.C. §§ 541-547.

97. See Rev. Rul. 74-269, 1974-1 C.B. 87 (rules for gift tax treatment of preferred stock recapitalizations). No gift tax is due unless the value of the preferred stock received by the majority stockholder is less than the surrendered common stock's value. In such a case, the difference will be treated as a taxable gift under I.R.C. § 2512(b): "[w]here property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift . . . ."

Treas. Reg. § 25.2512-8 (1958) provides a limited exception to the general rule of taxation of transfers for insufficient consideration. "[A] sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." *Id.* Some transactions have been able to fall within the exemption as bona fide plans to transfer control to business executives. See *Messing v. Commissioner*, 48 T.C. 502, 511 (1967), *acq.* 1968-1 C.B. 2; *Estate of Anderson v. Commissioner*, 8 T.C. 706, 718-20 (1947).

98. Under current law, the value of the founder's retained voting control is not includable for purposes of federal estate taxation of the founder's corporate interest. The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009, 90 Stat. 1520, amended the Code to provide in § 2036(b) for the inclusion in a decedent's gross estate of transferred shares of stock in a controlled corporation if the right to vote the shares either directly or indirectly is retained by the decedent, thus limiting a device for tax avoidance permitted under prior case law. Cf. *United States v. Byrum*, 408 U.S. 125, 138 n.13 (1972) ("Although in this case Byrum possessed 'voting control' . . . , the concept is too variable and imprecise to constitute the basis *per se* for imposing tax liability . . . ."); *Estate of Gilman v. Commissioner*, 65 T.C. 296, 310 (1975) (shares not includable in gross estate where decedent retained right to vote as trustee). See generally Clark, *Supreme Court Says Grantor May Retain Voting Control of Stock Placed in Trust*, 37 J. TAX. 138 (1972); Moore, *Byrum Revisited*, 27 U. S. CAL. TAX INST. 439 (1975); Pressment, *Effect of Tax Court's Gilman Decision on Estate Planning for the Close Corporation*, 44 J. TAX. 160 (1976). The recapitalization device, however, apparently does not fall within the purview of I.R.C. § 2036(b). Voting control is not retained in transferred shares, but is maintained through ownership of the majority of the newly issued stock.

99. The use of the recapitalization device for close corporation succession purposes has had the long-standing approval of the courts, beginning with the case of *Hartzel v. Commissioner*, 40 B.T.A. 492 (1939), *acq.* 1939-2 C.B. 16, and approval of the Internal Revenue Service, see Rev. Rul. 54-13, 1954-1 C.B. 109; Rev. Rul. 55-112, 1955-1 C.B. 344. Consequently, there have been few IRS challenges of such schemes provided that taxpayers



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devices are analyzed under the proposed reciprocal insurance model, however, their tax avoidance purpose becomes apparent.

The preferred stock recapitalization (and its progeny) can be restyled in the restrictive agreement form. In essence, the initiator of such a plan enters into a binding option arrangement under which his interest in a business is transferred to other business associates at a formulaic or stated value, equaling the value of that interest at the time of the transaction, paid in the form of preferred stock.<sup>100</sup> As in the restrictive agreement context, this option price is intended to be determinative of the value of the transferor's business interest for estate tax purposes.

The three tests of the proposed reciprocal insurance standard reveal the deficiencies of such arrangements. Although recapitalization plans are generally recognized by courts as valid and enforceable and are sufficiently restrictive,<sup>101</sup> they may be unacceptable under the second requirement of the proposed standard. The recapitalization and other dual stock structure plans can be employed to divert the value of future business growth to individuals who have little commitment to the affairs of the closely held business.<sup>102</sup> Accordingly, it would be difficult to demonstrate that the transferor and transferees have mutual insurable business interests.<sup>103</sup>

Moreover, the net economic effect test is an insuperable barrier to recognition of the arrangement for estate tax valuation purposes: the effect of a preferred stock recapitalization is grossly disproportionate with respect to the parties. This disparity demonstrates the fundamental difference between the preferred stock recapitalization and its restrictive agreement counterpart. The latter is an arrangement for

have complied with the basic rules governing gift and income taxation with respect to gift tax valuation, *see* I.R.C. § 2512(b), dividends, *see id.* §§ 305(b)(3), (c), 306, and reorganizations, *see id.* § 368(a)(1)(E).

100. Assuming that the stated dividend rate is equal to the market rate of the interest, the option price is simply the value of the interest, as represented by the preferred stock principal, without inclusion of an additional amount representing future dividends. These dividends constitute the earnings of the preferred stock over time; that is, if all these dividends are discounted to present value, they will equal the current preferred principal.

101. The restrictive requirement is apparently satisfied, because the transferor must dispose of his interest to the other owners of the close corporation stock under a binding plan.

102. *See* Cooper, *supra* note 94, at 174 n.25 (estate and gift tax consequences of preferred stock recapitalization identical regardless of whether or not heir ever participates in business).

103. In fact, the transferees will usually achieve more benefit from the transferor's death than from his continued life, since it is only then that the business is free from the transferor's control and can be sold by the transferees.

the transfer of a business associate's entire interest in a closely held business at an agreed-upon price upon his death or retirement. In the former, only a portion of the owner's interest is being "purchased" at the stated value. The owner retains control over the corporation's management in the form of a voting majority of the outstanding stock, but loses all rights to participation in future profits. The transferees continue to be minority stockholders, but as a result of the transaction acquire the entire value of the company's potential growth at the cost of only the transferor's preferred stock.

In short, preferred stock recapitalization techniques should not be eligible for special estate tax treatment. They are not designed to further the two basic legislative and judicial goals involved in the recognition of restrictive agreements: they fail to ensure continuity in closely held businesses upon the retirement or death of a business associate, and they do not prevent unnecessary tax avoidance. These schemes are instead estate tax dodges disguised in the form of complex close corporation arrangements.

## Conclusion

This Note proposes a reciprocal insurance standard as an appropriate and feasible method of implementing legislative and judicial objectives in the context of restrictive agreements. By emphasizing the essential insurance characteristics of restrictive agreements, it is possible to determine the conclusiveness of such arrangements for estate tax valuation purposes without regard to such troublesome concepts as "bona fides" and "intent." Past history has demonstrated that tests based on these indefinite and subjective concepts yield nothing but inconsistency and confusion.

The proposed test would have distinct advantages over existing statutory schemes and judicial doctrines. It would provide a definite and intelligible rule that is manageable by courts, revenue collectors, and taxpayers. As a result, the reciprocal insurance standard would facilitate tax and structural planning in closely held businesses, promote judicial uniformity, and reduce litigation.